

firm to lease the apartments, manage the buildings and pay over the net rents to the owner. The rental income of *E* Corporation from such leases is not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 5.* Controlled foreign corporation *F* acquired by purchase a twenty-story office building in a foreign country, three floors of which it occupies and the rest of which it leases. Corporation *F* acts as rental agent for the leasing of offices in the building and employs a substantial staff to perform other management and maintenance functions. Under paragraph (c)(1)(ii) of this section, the rents received by Corporation *F* from such leasing operations are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 6.* Controlled foreign corporation *G* owns equipment which it ordinarily uses to perform contracts in foreign countries to drill oil wells. For occasional brief and irregular periods it is unable to obtain contracts requiring immediate performance sufficient to employ all such equipment. During such a period it sometimes leases such idle equipment temporarily. After the expiration of such temporary leasing of the property, Corporation *G* continues the use of such equipment in the performance of its own drilling contracts. Under paragraph (c)(1)(iii) of this section, rents *G* receives from such leasing of idle equipment are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

(d) *Excluded royalties*—(1) *Trade or business cases.* Royalties will be considered for purposes of paragraph (b)(5) of this section to be derived in the active conduct of a trade or business if such royalties are derived by the controlled foreign corporation (“licensor”) from licensing— (i) Property which the licensor has developed, created, or produced, or has acquired and added substantial value to, but only so long as the licensor is regularly engaged in the development, creation, or production of, or in the acquisition of and addition of substantial value to, property of such kind, or

(ii) Property which is licensed as a result of the performance of marketing functions by such licensor and the licensor, through its own staff of employees located in a foreign country, maintains and operates an organization in such country which is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and which is substantial in relation to the amount of royalties

derived from the licensing of such property.

(2) *Special rules*—(i) *Adding substantial value.* For purposes of paragraph (d)(1)(i), the performance of marketing functions will not be considered to add substantial value to property.

(ii) *Substantiality of foreign organization.* An organization in a foreign country will be considered substantial in relation to the amount of royalties, for purposes of paragraph (d)(1)(ii) of this section, if the active licensing expenses, as defined in paragraph (d)(2)(iii) of this section, equal or exceed 25 percent of the adjusted licensing profit, as defined in paragraph (d)(2)(iv) of this section.

(iii) *Active licensing expenses.* The term “active licensing expenses” means the deductions incurred by an organization of the licensor which are properly allocable to royalty income and which would be allowable under section 162 to the licensor (were the licensor a domestic corporation) other than—

(A) Deductions for compensation for personal services rendered by shareholders of, or related persons with respect to, the licensor,

(B) Deductions for royalties paid or incurred,

(C) Deductions which, although generally allowable under section 162, would be specifically allowable to the licensor (were the controlled foreign corporation a domestic corporation) under sections other than section 162 (such as section 167), and

(D) Deductions for payments made to independent contractors with respect to the licensed property.

(iv) *Adjusted licensing profit.* The term “adjusted licensing profit” means the gross income of the licensor from royalties, reduced by the sum of—

(A) The royalties paid or incurred by the controlled foreign corporation with respect to such gross royalty income,

(B) The amounts which would be allowable to such licensor as deductions under section 167 (were the licensor a domestic corporation) with respect to such royalty income, and

(C) The amounts paid to independent contractors with respect to such royalty income.

(3) *Illustrations.* The application of this paragraph (d) is illustrated by the following examples.

*Example 1.* Controlled foreign corporation A, through its own staff of employees, owns and operates a research facility in foreign country X. At the research facility employees of Corporation A who are full time scientists, engineers, and technicians regularly perform experiments, tests, and other technical activities, which ultimately result in the issuance of patents that it sells or licenses. Under paragraph (d)(1)(i) of this section, royalties received by Corporation A for the privilege of using patented rights which it develops as a result of such research activity are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 2.* Assume that Corporation A in example 1, in addition to receiving royalties for the use of patents which it develops, receives royalties for the use of patents which it acquires by purchase and licenses to others without adding any value thereto. Corporation A generally consummates royalty agreements on such purchased patents as the result of inquiries received by it from prospective licensees when the fact becomes known in the business community, as a result of the filing of a patent, advertisements in trade journals, announcements, and contacts by employees of Corporation A, that Corporation A has acquired rights under a patent and is interested in licensing its rights. Corporation A does not, however, maintain and operate an organization in a foreign country which is regularly engaged in the business of marketing the purchased patents. The royalties received by Corporation A for the use of the purchased patents are not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 3.* Controlled foreign corporation B receives royalties for the use of patents which it acquires by purchase. The primary business of Corporation B, operated on a regular basis, consists of licensing patents which it has purchased "raw" from inventors and, through the efforts of a substantial staff of employees consisting of scientists, engineers, and technicians, made susceptible to commercial application. For example, Corporation B, after purchasing patent rights covering a chemical process, designs specialized production equipment required for the commercial adaptation of the process and, by so doing, substantially increases the value of the patent. Under paragraph (d)(1)(i) of this section, royalties received by Corporation B from the use of such patent are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

*Example 4.* Controlled foreign corporation D finances independent persons in the devel-

opment of patented items in return for an ownership interest in such items from which it derives a percentage of royalty income, if any, subsequently derived from the use by others of the protected right. Corporation D also attempts to increase its royalty income from such patents by contacting prospective licensees and rendering to licensees advice which is intended to promote the use of the patented property. Corporation D does not, however, maintain and operate an organization in a foreign country which is regularly engaged in the business of marketing the patents. Royalties received by Corporation D for the use of such patents are not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

(e) *Certain property transactions—(1) In general—(i) Inclusion in FPHC income.* Foreign personal holding company income includes the excess of gains over losses from the sale or exchange of—

(A) Property which gives rise to dividends, interest, rents, royalties or annuities as described in paragraph (e)(2) of this section, and

(B) Property which does not give rise to income, as described in paragraph (e)(3) of this section.

If losses from the sale or exchange of such property exceed gains, the net loss is not within the definition of foreign personal holding company income under this paragraph (e), and may not be allocated to, or otherwise reduce, other foreign personal holding company income under section 954(b)(5) and § 1.954-1T(c). Gain or loss from a transaction that is treated as capital gain or loss under section 988(a)(1)(B) is not foreign currency gain or loss as defined in paragraph (g), but is gain or loss from the sale or exchange of property which is included in the computation of foreign personal holding company income under this paragraph (e)(1). Paragraphs (e) (4) and (5) of this section provide specific rules for determining whether gain or loss from dispositions of debt instruments and dispositions of options or similar property must be included in the computation of foreign personal holding company income under this paragraph (e)(1). A loss that is deferred or that otherwise may not be taken into account under any provision of the Code may not be taken into account for purposes of determining foreign personal holding company

income under any provision of this paragraph (e).

(ii) *Dual character property.* Property may only in part constitute property that gives rise to certain income as described in paragraph (e)(2) of this section or property that does not give rise to any income as described in paragraph (e)(3) of this section. In such cases, the property must be treated as two separate properties for purposes of this paragraph (e). Accordingly, the sale or exchange of such dual character property will give rise to gain or loss that in part must be included in the computation of foreign personal holding company income under this paragraph (e), and in part is excluded from such computation. Gain or loss from the disposition of dual character property must be bifurcated for purposes of this paragraph (e)(1)(i) pursuant to the method that most reasonably reflects the relative uses of the property. Reasonable methods may include comparisons in terms of gross income generated or the physical division of the property. In the case of real property, the physical division of the property will in most cases be the most reasonable method available. For example, if a controlled foreign corporation owns an office building, uses 60 percent of the building in its business, and rents out the other 40 percent, then 40 percent of the gain recognized on the disposition of the property would reasonably be treated as gain which is included in the computation of foreign personal holding company income under this paragraph (e)(1). This paragraph (e)(1)(ii) addresses the contemporaneous use of property for dual purposes; for rules concerning changes in the use of property affecting its classification for purposes of this paragraph (e), see paragraph (a)(3) of this section.

(2) *Property that gives rise to certain income—(i) In general.* Property the sale or exchange of which gives rise to foreign personal holding company income under this paragraph (e)(2) includes property that gives rise to dividends, interest, rents, royalties and annuities described in paragraph (b) of this section, except for rents and royalties derived from unrelated persons in the active conduct of a trade or business under paragraph (b)(5) of this section.

The property described by this paragraph (e)(2) includes property which gives rise to export financing interest described in paragraph (b)(2) of this section and property which gives rise to income from related persons described in paragraphs (b)(3) and (b)(4) of this section.

(ii) *Exception.* Property described in this paragraph (e)(2) does not include—

(A) Dealer property (as defined in paragraph (a)(4)(iv) of this section), and

(B) Inventory and similar property (as defined in paragraph (a)(4)(ii) of this section) other than securities.

(3) *Property that does not give rise to income.* The term “property that does not give rise to income” for purposes of this section includes all rights and interests in property (whether or not a capital asset) except—

(i) Property that gives rise to dividends, interest, rents, royalties and annuities described in paragraph (e)(2) of this section and property that gives rise to rents and royalties derived in the active conduct of a trade or business under paragraph (b)(5) of this section;

(ii) Dealer property (as defined in paragraph (a)(4)(iv) of this section);

(iii) Inventory and similar property (as defined in paragraph (a)(4)(ii)) other than securities;

(iv) Property (other than real property) used in the controlled foreign corporation's trade or business that is of a character which would be subject to the allowance for depreciation under section 167 or 168 and the regulations thereunder (including tangible property described in §1.167(a)-2 and intangibles described in §1.167(a)-3);

(v) Real property that does not give rise to rental or similar income, to the extent used in the controlled foreign corporation's trade or business; and

(vi) Intangible property as defined in section 936(h)(3)(B) and goodwill that is not subject to the allowance for depreciation under section 167 and the regulations thereunder to the extent used in the controlled foreign corporation's trade or business and disposed of in connection with the sale of a trade or business of the controlled foreign corporation.

(4) *Classification of gain or loss from the disposition of a debt instrument or on a deferred payment sale*—(i) *Gain*. Gain from the sale, exchange, or retirement of a debt instrument is included in the computation of foreign personal holding company income under this paragraph (e) unless—

(A) It is treated as interest income (as defined in paragraph (a)(4)(i) of this section); or

(B) It is treated as income equivalent to interest under paragraph (h) of this section.

(ii) *Loss*. Loss from the sale, exchange, or retirement of a debt instrument is included in the computation of foreign personal holding company income under this paragraph (e) unless—

(A) It is directly allocated to interest income (as defined in paragraph (a)(4)(i) of this section) or income equivalent to interest (as defined in paragraph (h) of this section) under any provision of the Code or regulations thereunder;

(B) It is required to be apportioned in the same manner as interest expense under section 864(e) or any other provision of the Code or regulations thereunder; or

(C) The debt instrument was taken in consideration for the sale or exchange of property (or the provision of services) by the controlled foreign corporation and gain or loss from that sale or exchange (or income from the provision of services) is not includible in foreign base company income under this section.

(5) *Classification of options and other rights to acquire or transfer property*. Subject to the exceptions provided in paragraphs (e)(3) (ii) and (iii) of this section (relating to certain dealer property and inventory property), rights to acquire or transfer property, including property that gives rise to income, are classified as property that does not give rise to income under paragraph (e)(3) of this section. These rights include options, warrants, futures contracts, options on a futures contract, forward contracts, and op-

tions on an index relating to stocks, securities or interest rates.

(6) *Classification of certain interests in pass through entities*. [Reserved.]

(f) *Commodities transactions*—(1) *In general*. Except as otherwise provided in this paragraph (f), foreign personal holding company income includes the excess of gains over losses from commodities transactions. If losses from commodities transactions exceed gains, the net loss is not within the definition of foreign personal holding company income under this paragraph (f), and may not be allocated to, or otherwise reduce, foreign personal holding company income under section 954(b)(5) and § 1.954-1T(a)(4). The terms “commodity” and “commodities transactions” are defined in paragraph (f)(2) of this section. Gains and losses from qualified active sales and qualified hedging transactions are excluded from the computation of foreign personal holding company income under this paragraph (f). The term “qualified active sales” is defined in paragraph (f)(3). The term “qualified hedging transaction” is defined in paragraph (f)(4) of this section. An election is provided under paragraph (g)(5) of this section to include all gains and losses from section 1256 foreign currency transactions, which would otherwise be commodities transactions, in the computation of foreign personal holding company income under paragraph (g) instead of this paragraph (f). A loss that is deferred or that otherwise may not be taken into account under any provision of the Code may not be taken into account for purposes of determining foreign personal holding company income under any provision of this paragraph (f).

(2) *Definitions*—(i) *Commodity*. For purposes of this section, the term “commodity” means:

(A) Tangible personal property of a kind which is actively traded or with respect to which contractual interests are actively traded, and

(B) Nonfunctional currency (as defined under section 988 and the regulations thereunder).

(ii) *Commodities transaction.* A commodities transaction means the purchase or sale of a commodity for immediate (spot) delivery, or deferred (forward) delivery, or the right to purchase, sell, receive, or transfer a commodity, or any other right or obligation with respect to a commodity, accomplished through a cash or off-exchange market, an interbank market, an organized exchange or board of trade, an over-the-counter market, or in a transaction effected between private parties outside of any market. Commodities transactions include, but are not limited to:

(A) A futures or forward contract in a commodity,

(B) A leverage contract in a commodity purchased from leverage transaction merchants,

(C) An exchange of futures for physical transaction,

(D) A transaction in which the income or loss to the parties is measured by reference to the price of a commodity, a pool of commodities, or an index of commodities,

(E) The purchase or sale of an option or other right to acquire or transfer a commodity, a futures contract in a commodity, or an index of commodities, and

(F) The delivery of one commodity in exchange for the delivery of another commodity, the same commodity at another time, cash, or nonfunctional currency.

(3) *Definition of the term "qualified active sales"*—(i) *In general.* The term "qualified active sales" means the sale of commodities in the active conduct of a commodity business as a producer, processor, merchant, or handler of commodities if substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities of like kind. The sale of commodities held by a controlled foreign corporation other than in its capacity as an active producer, processor, merchant or handler of commodities of like kind is not a qualified active sale.

(ii) *Sale of commodities.* The term "sale of commodities" means any transaction in which the controlled foreign corporation intends to deliver to a purchaser a commodity held by

the controlled foreign corporation in physical form.

(iii) *Active conduct of a commodities business.* For purposes of this paragraph, a controlled foreign corporation is engaged in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities only if—

(A) It holds commodities as inventory or similar property (as defined in paragraph (a)(4)(ii)); and

(B) It incurs substantial expenses in the ordinary course of a commodities business from engaging in one of the following activities directly, and not through an independent contractor:

(1) Substantial activities in the production of commodities, including planting, tending or harvesting crops, raising or slaughtering livestock, or extracting minerals.

(2) Substantial processing activities prior to the sale of commodities including concentrating, refining, mixing, crushing, aerating, or milling; or

(3) Significant activities relating to the physical movement, handling and storage of commodities including preparation of contracts and invoices; arranging freight, insurance and credit; arranging for receipt, transfer or negotiation of shipping documents; arranging storage or warehousing, and dealing with quality claims; owning and operating facilities for storage or warehousing or owning or chartering vessels or vehicles for the transportation of commodities.

For purposes of this paragraph (f), a corporation is not engaged in a commodities business as a producer, processor, merchant, or handler of commodities if its business is primarily financial. In general, the business of a controlled foreign corporation is financial if it primarily engages in commodities transactions for investment or speculation, or if it primarily provides products or services to customers for investment or speculation.

(iv) *Substantially all.* Substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities if the activities described in paragraph (f)(3)(iii) give rise to 85 percent of the taxable income of the controlled foreign corporation (computed